Financing the transition to a sustainable economy
Informal ECOFIN, April 22, 2016
Presidency note

Ambitious steps are needed to support the transition towards a low-carbon economy in the next decades. In that respect, the Paris agreement marks a turning point. The transformation process creates challenges as well as opportunities for the financial sector to facilitate sustainable investments and manage climate risks. These issues are on the agenda of the G20, which has initiated the Green Finance study group.

As the world's largest economy with a highly developed financial system, the European Union has the critical mass that is needed to give momentum to the transformation process. To date, the majority of assets managed according to environmental, social and governance principles are based in Europe.
The financial sector can support the transition to a sustainable economy in several ways. Financial intermediation mobilizes savings to fund profitable sustainable investments. Financial markets and infrastructure are essential for adequate pricing and tradability of carbon risk. The financial sector is also important to manage climate risk, by providing insurance and financial instruments to hedge such risks. Through all these activities, the financial sector can contribute to a smooth transition.

A number of promising initiatives have been launched in recent years. Financial institutions have committed themselves to adopt environmental principles into their investment targets and risk management frameworks (e.g. the Equator Principles). Investment products have been developed, such as green bonds and sustainable investment funds. Financial services and tools have been created to improve transparency, including e.g. carbon footprint measures and investment indices.

At the same time, there is still a lot of scope for improvement. While current initiatives are promising, they represent a very small proportion of financial exposures. Moreover, initiatives are fragmented and would benefit from more standardization and stronger incentives across the entire economy to take into account climate risks:

- More standardization would help to improve transparency and to develop sustainable projects that are attractive to a broad group of investors. Currently, there are almost 400 information disclosure schemes from a variety of sources.
- As carbon emissions are currently underpriced, they do not provide the right incentives to take them into account in investment decisions and risk management.

More standardization and aligning price incentives with the underlying climate risks would help to boost sustainable investments and facilitate the transition to a low-carbon economy. Standardization and larger volumes would generate economies of scale. As to transparency, several member states have taken steps to enhance firms' disclosure on sustainability, while at the EU level the Non-Financial Reporting Directive will require large companies to report on environmental issues. The Union is well-positioned to play a leading role and support similar initiatives at the global level, such as the FSB climate disclosure taskforce. Regarding investment decisions, a strong, prudent and stable regulatory environment would reduce uncertainty, which is important given the long-term nature of investments. The Capital Market Union initiative provides an excellent opportunity to further strengthen the development of financial instruments, such as green bonds.

While more transparency and price incentives would contribute to a smooth transition, it remains important to monitor potential systemic risks for the financial sector. Financial firms are potentially exposed to stranded assets and sectors that need to adjust. This includes relatively energy intensive sectors (e.g. steel, transport) but also, for instance, real estate. Moreover, in addition to transition risk, the financial sector is also

exposed to risks related to climate change itself (e.g. extreme weather, floods). Stress testing can be an important tool to assess these risks. Currently, there are promising initiatives to develop the methodology for carbon stress testing, for instance by the Green Finance study group and UNEP. Supervisors should monitor these risks and take prudential action when these are insufficiently managed.

Issues for discussion

1. Are bottom-up initiatives by the private sector an efficient way to promote sustainable investments? Is there a coordinating role for public authorities?
2. How can the EU support the work of the FSB climate disclosure taskforce to increase transparency; which elements do you think are most important?
3. What could be the role of financial regulation and supervision to promote sustainable finance? For example, do you see added value of 'carbon stresstests' to strengthen investor awareness and promote financial stability?
4. How can the Capital Markets Union support the development of a market for sustainable finance in green assets?